

NCUA LETTER TO CREDIT UNIONS

NATIONAL CREDIT UNION ADMINISTRATION

1775 Duke Street, Alexandria, VA 22314

DATE: August 2008 **LETTER NO.:** 08-CU-19

TO: Federally Insured Credit Unions

SUBJ: Third-Party Relationships: Mortgage Brokers and Correspondents

REF:

- (1) Evaluating Third Party Relationships (LCU 07-CU-13)**
- (2) Managing Risks Associated with Home Equity Lending (LCU 05-CU-07)**
- (3) Specialized Lending Activities – Third-Party Subprime Indirect Lending and Participations (05-Risk-01)**
- (4) Office of the Comptroller of the Currency Advisory Letter 2003-3 – Avoiding Predatory and Abusive Lending Practices in Brokered and Purchased Loans**

Dear Board of Directors:

The purpose of this Letter to Credit Unions is to re-emphasize the importance of proper due diligence over third-party relationships, specifically as they relate to the use of mortgage brokers and correspondents.

Statistics show that mortgage brokers originate the majority of home mortgages.¹ Credit unions are seeking out nontraditional channels for growing their loan portfolios, and in doing so are more frequently using the services of a mortgage broker or correspondent. Mortgage brokers and correspondents have very similar roles in the lending process, with the primary differences being that brokers generally do not fund loans and are working on behalf of the credit union or borrower, whereas correspondents fund and close loans in their own name and subsequently sell the loan to a credit union, or other lender.

Both brokers and correspondents are compensated based upon mortgage origination volume and, accordingly, have an incentive to produce and close as many loans as possible. Therefore, credit unions should perform comprehensive

¹ The National Association of Mortgage Brokers, and other sources, state that over 50 percent of home loans are originated by mortgage brokers.

due diligence on third-party originators prior to entering into a relationship. In addition, once a relationship is established, the credit union should have adequate audit procedures and controls to verify that fees paid to third parties are legitimate, that mortgage applications are complete and do not contain fraud, and that referral or unearned income or fees are legal and not contrary to RESPA prohibitions.² Monitoring the quality of loans by origination source, and uncovering such problems as early payment defaults and incomplete packages, enables management to determine if third-party originators are producing quality loans.

Due Diligence

Letter to Credit Unions 07-CU-13, Evaluating Third Party Relationships, provides significant detail regarding due diligence required prior to entering into third-party relationships as well as the ongoing due diligence needed to monitor those relationships. Prior to entering into any relationship with a mortgage broker or correspondent, a credit union should consider the following:

Background check – Has a background check been performed on the business and on the key individuals involved in the transactions, and does the check include such items as: complaints filed against those parties, licensure status (if applicable),³ and past and current lawsuits? There are many potential sources of information, such as the Better Business Bureau, the Federal Trade Commission, state agencies, credit reporting agencies, and current and prior clients.

Business practices and operations, including potential conflicts of interest – Does the third party have a sound business model for long-term operations? Who owns or has a controlling influence over companies providing related services to the broker or correspondent (e.g., appraisers, title companies, insurance companies, etc.)?

Financial Standing – What is the third party's financial condition, is their cash flow adequate, can they provide independently audited financial statements?

Accounting Considerations – How does the cash flow through their operation and between all parties involved, can the cash flows be independently verified, what are the sources of cash, and are they complying with Generally Accepted Accounting Principles in maintaining their accounting records?

Internal controls – Do they have sound internal controls to help prevent fraud and abuse, and to ensure compliance with consumer laws and regulations?

² The Real Estate Settlement and Procedures Act (RESPA) prohibits kickbacks or unearned referral fees that tend to unnecessarily increase the cost of certain settlement services.

³ There is no federal licensing or continuing education requirements for mortgage brokers or correspondents. Whether a broker or correspondent is required to be licensed is established by each state with each state setting its own licensing standards.

Contract Issues and Legal Review – Is the credit union adequately protected and are there adequate default, termination, and escape clauses? Are there agreements that the broker or originator will comply with all applicable laws, including safety and soundness regulatory standards applicable to credit unions? Does the agreement stipulate that best efforts will be made by originators to ensure loans offered to borrowers are consistent with their needs, objectives, and financial situation? Credit unions should reserve the right to not purchase, or to put back to the broker or originator, any loans failing to comply with these standards.

Additionally, in performing due diligence in the use of mortgage brokers and correspondents, credit unions should also be aware of the following potential issues:

- ⇒ The broker or correspondent may be operating in their own best interests and not necessarily putting the interests of the credit union or the member first;
- ⇒ Fees and yield spread premiums paid to the third parties may be excessive, and the existence of prepayment penalties may not be clear to the borrower at the time they obtained the loan, or may serve as a deterrent to refinancing early in the lending relationship should financial difficulties with the member occur;⁴
- ⇒ Loan fees, terms, and practices that are abusive or considered “predatory”⁵ could lead to significant legal, reputation, and other risks to the credit union;
- ⇒ Obtaining or retaining loans with repayment based on a member’s stated income (i.e., unverified income) are high risk loans, especially when the amount of income stated does not pass the reasonableness test;
- ⇒ Control over the appraisal process can be compromised if the credit union is not obtaining the appraisals directly or is not closely monitoring the quality of completed appraisals;
- ⇒ The broker or correspondent could structure the transactions to limit their liability. They may have no continuing liability after the credit union finalizes the loan or loan purchase;
- ⇒ The broker or correspondent may not have the financial capability to continue operations over the long-term or the ability to support any claims that may arise;

⁴ Federal Credit Unions cannot impose prepayments penalties on loans they grant or enforce a prepayment penalty that may exist in a loan contract they participate in or purchase, per 12 U.S.C. 107(5)(A)(viii) of the Federal Credit Union Act, 701.21(c)(6) of the NCUA Rules and Regulations, and further discussed in existing NCUA legal opinions. Whether loan prepayment penalties are allowed for state chartered credit unions is determined at the state level.

⁵ Letter to Credit Unions 07-CU-09, Subprime Mortgage Lending, includes an Interagency Statement which addresses, among other concerns, risk considerations associated with predatory lending. OCC Advisory Letter AL 2003-3 referenced above also provides detail regarding applicable compliance laws and guidance on avoiding predatory or abusive lending.

- ⇒ Closed loan documents may not be reflective of written or verbal agreements;
- ⇒ Product volume may develop at a level in excess of what the third party and/or the credit union can safely manage; and
- ⇒ Funding commitments may have to be honored despite developing concerns with the third-party relationship or the loan program in general.

This is not an exhaustive list of considerations, but represents some of the key issues management needs to be mindful of before entering into a mortgage broker or correspondent relationship, and ongoing throughout the relationship.

Risk Management Considerations

Whenever a credit union outsources a function, it is relinquishing some level of control over that function. To adjust for the lack of direct oversight over outsourced transactions and services, compensating controls need to be implemented over the life of the third-party relationship.

When dealing with mortgage brokers and correspondents, compensatory controls need to ensure:

- ⇒ Adherence to board established lending policies and risk parameters.⁶ A sufficient sample of loans, underwritten by a broker or correspondent must be reviewed for compliance with board policies, applicable regulations, and written agreements to ensure that ongoing loan quality is maintained. Additional targeted loan reviews should be performed based on any performance concerns of a third-party such as increasing default rates, foreclosure rates, complaints, and higher than average fees charged to borrowers.
- ⇒ Loan approval authority, in the use of a mortgage broker, is not delegated to the broker, and that all loan underwriting criteria and subsequent modifications are approved by the credit union.⁷
- ⇒ Broker and correspondent reports are accurate, timely, and contain sufficient detail to adequately monitor activity.

If ongoing credit or documentation problems are discovered, the credit union should take appropriate action, which could include modification of contract terms or terminating the relationship.

⁶ Board policies need to address such issues as: frequent, sequential refinancings with little to no economic benefit to the borrower, negatively amortizing loans, prepayment penalties that are not limited to the early years of the loans, financing points, fees, penalties, and other charges, allowing non-owner occupied property financing, and balloon payments in short-term transactions.

⁷ Delegation of those authorities to a third party would be a violation of §113 of the FCU Act for federal credit unions, and an unsafe and unsound practice for all federally-insured credit unions, which could be subject to possible NCUA action under §206 of the FCU Act.

Conclusion

Third parties, including brokers and correspondents, can and will continue to play an important and ever-increasing role in how credit unions operate. While a broker or correspondent can assist in facilitating transactions, credit union management is responsible for controlling the risk being added to the balance sheet. Credit union management, not the broker or correspondent, has the fiduciary responsibility for deciding what is best for the credit union and the membership. Given these responsibilities, it is imperative that credit unions keep the following in mind:

- ⇒ Board established lending policies and procedures should be established to fit the product -- with risk tolerance levels based on management analysis, established regulatory thresholds, and sound business rationale;
- ⇒ Loan growth should be slow and controlled, activity should be within reasonable risk thresholds, and building a concentration in a particular loan type and/or in an unfamiliar geographic area should be avoided; and
- ⇒ Broker and correspondent relationships need to receive ongoing due diligence commensurate with the risk and complexity of those activities, regardless of whether the third party has a credit union affiliation, such as being part of a credit union service organization.

I continue to encourage you to remain diligent in your oversight of third-party relationships, including mortgage brokers and correspondents.

If you have questions regarding this Letter to Credit Unions, please contact your district examiner, regional office, or state supervisory authority.

Sincerely,

/s/

Michael E. Fryzel
Chairman